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Lessons Learned from Past Financial Crises: Korea 1998-2000 - Investing Equity/Quasi- Equity with Agility in Financial Institutions

IFC was very active in the Republic of Korea immediately after the Asian financial crisis erupted in 1997. IFC reestablished operations in Korea and opened a local office in October 1998, and closed it in late 2002 after Korea recovered from the crisis.

At the end of 1997, the Korean economy suddenly started to contract, the Korean won plummeted by over 100 percent against the US dollar, and liquidity in the banking sector dried up. Major commercial banks as well as smaller specialized financial institutions all faced increases in non-performing loans and were unable to roll over their shorter-term funding.

In response to this crisis, IFC's first priority was to strengthen financial institutions through both financing and advisory services, and enable them to lead the restructuring process. IFC then injected liquidity into the trading system through trade enhancement facilities. IFC supported the restructuring of corporations facing liquidity problems and helped its clients grow as the recovery began.

Between 1997 and 2002, IFC invested almost US\$1 billion in Korea for a total project cost of about US\$3 billion. Most investments were made in 1998 and 1999. The crisis response strategy focused on the financial sector, and also supported corporate governance and improvements in transparency and disclosure standards to help modernize financial markets and improve their efficiency. In the corporate sector, IFC helped restructure Korean companies through direct investments complemented by advisory services.

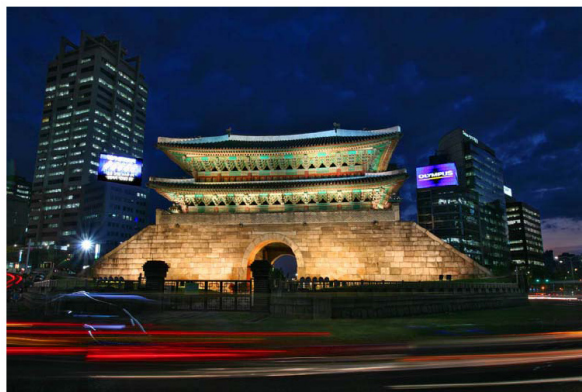
IFC helped strengthen Korea's financial sector by giving priority to financial sector reform. The Board

approved investments of about US\$670 million in 16 banks and finance companies.

IFC focused on:

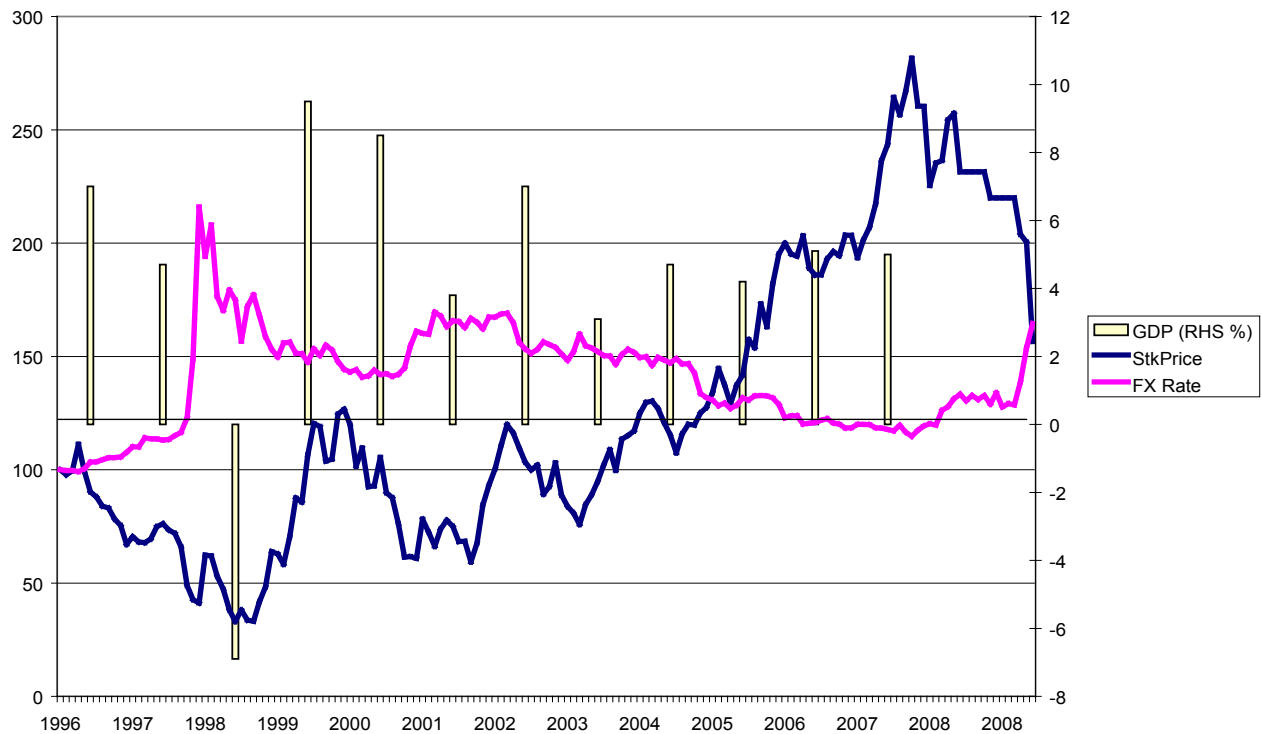
- *Strengthening existing banks and non-banks (life insurance, leasing, stock/futures brokerage)*
- *Establishing new institutions to broaden the capital markets (mutual fund management, pension fund management, secondary mortgage finance)*
- *Strengthening the financial infrastructure through the establishment of credit rating agencies and credit bureaus*
- *Introducing financing and risk management instruments and techniques such as securitization and derivative products to the local capital markets.*

The results for IFC were far-reaching. IFC got publicity highlighting its ability to quickly close a deal once the deal structure was accepted by a particular client. Frequent press releases, deal-signing ceremonies, and even prime-time TV interviews of IFC senior management reinforced IFC's positive image. In addition, goodwill was generated with local authorities and contacts at all levels of the Korean



Sungnyemun Gate in Seoul, South Korea

Korea: Macro-Indicators



administration, creating an image of IFC as a “get things done” organization.

IFC’s ability to respond quickly, assess risks, and put mitigating measures in place, as well as its client relationship skills, enabled IFC to provide significant assistance to Korea’s financial sector and thereby contribute to its recovery.

The graph above clearly illustrates that the “perfect storm” was set for the period from January 1998–March 1999 when:

- *The Korean won was at its lowest level against the US dollar in May 1998*
- *The stock market index was at the bottom (it went from 30 in July 1998 to 105 in June 2000, a 3.5 time increase)*
- *Gross domestic product (GDP) was on a trend to bounce back from -7% in 1998 to +9% in 1999.*

This is a classic case of “a V-shaped recovery,” and it is important to take advantage of the equity window in such cases. The Korean economic and financial recovery was helped by vigorous structural reforms of the economy influenced by the World Bank/ International Monetary Fund rescue package, and strong exports from Korean companies to the United States. While such a situation might not happen under the current global crisis, the lessons learned from investing in Korea during 1998-2000 can provide useful guidance to IFC investment professionals at this time.

This paper describes seven lessons learned from Korea that we hope are helpful to IFC staff during the current global

financial crisis when investing equity in financial institutions.

Lessons Learned

1) *Equity/quasi-equity investments make sense in a crisis situation and require strong legal support.*

At the outset of the Asian crisis, investment staff were instructed by IFC Senior Management to originate and process equity deals and avoid loans because experienced staff time was scarce. It takes longer to negotiate a loan than an equity investment when spreads are very volatile. This is still the case today. During the 1994 economic crisis in Mexico, IFC found that by the time it had finalized the documentation for senior loans with clients, the equity markets had recovered and spreads had to be renegotiated downward, resulting in the loss of capital gain opportunities for IFC. Thus, IFC found that it would have a stronger impact through equity investments rather than loans, due to the lengthy process involved in closing the negotiations for loans in a crisis situation (no pricing benchmark).

Equity investments offer a better risk/reward trade-off than loans. To facilitate an equity/quasi-equity investment program in Korea, IFC hired top-notch Wall Street lawyers to lead the documentation process alongside IFC’s investment team. Once IFC closed one deal, we found that the legal documentation and deal structure concepts could be used again for other deals.

Important features were: (a) creating anti-dilution clauses on convertible instruments (resetting the price per share

during the pre-conversion period, in case the company raises equity at a price below market); and (b) making hard-currency-denominated loans convertible into local currency-denominated shares, thereby hedging IFC's foreign-exchange exposure during the pre-conversion period. This illustrates the importance of having a streamlined legal process in place.

2) Advisory services are crucial during a crisis.

Specialized consultants can complement IFC staff during the due diligence process. This is particularly the case when there are tight deadlines, which is typical during crisis situations. (Vince Polizzato, IFC Chief Credit Officer, started working for IFC as a consultant in Korea).

Posting resident advisors in an investee company helps provide IFC with extremely valuable information that could not be obtained otherwise when structuring or supervising a deal. Resident advisors are consultants hired by IFC or an investee company to meet IFC's investment criteria. The resident advisor should bring a considerable level of experience to add value to senior executives and staff of local companies. He or she must be able to gain the trust of the investee company management, be an effective networker in emerging markets, and be able to work for a period of up to 2 years in an emerging market country. We should also stress that local consultants often have access and can convey to IFC what is happening "on the ground," and it is very important to engage and work closely with them.

Some examples of recommended advisory services programs that consultants can work on are:

- *Assigning a strategic advisor to work with the Chief Executive Officer*
- *Establishing a corporate work-out unit at a bank headquarters and training staff*
- *Strengthening the internal audit unit*
- *Preparing International Accounting Standards (IAS) consolidated accounts*
- *Posting a Board member with a special mandate to establish best practice corporate governance.*

Board representation and corporate governance are paramount when creating shareholder value, particularly in the case of IFC straight equity investments. IFC should be very demanding in this area. It is preferable that Board members be external consultants rather than IFC staff because they must act in the best interest of shareholders and their task can be very time-consuming.

3) The team booking the deal should also be in charge of supervision.

The team booking the deal should also be in charge of supervision in order to maximize return on IFC's due diligence and investment structure, at least for one-to-two years post-investment. Some equity investments and almost all quasi-equity investments are designed to mitigate downside risk and capture upside potential; however, the more structured the deals are, the more important

supervision is to take advantage of negotiated deal features. In addition, it is important to continue building-up the relationship with the investee company's senior management, Board, and key shareholders, supervise advisory services output, if relevant, and ensure that IFC delivers added value to the project and quickly reacts to possible eventual bad news during the portfolio supervision phase. If the same investment officer does the supervision, he or she can react faster in volatile situations because of familiarity with people, institutions, etc.

4) IFC is an agile organization, and working on IFC's countercyclical investments is rewarding.

Working on projects in crisis countries is hard work and extremely formative. During a crisis, IFC offers numerous opportunities for investment professionals to add value—striking at the core of IFC's mission. The experience in Korea showed that the investment approach in a crisis country requires a great deal of effort on the part of staff, as investments are often undertaken alongside co-investors and as part of turn-around programs/consortium of shareholders acquiring a controlling stake. Thus, the deal's timetable is dictated by the market. Deals are often high profile, and IFC investment staff must understand the big picture, be able to develop a vast network of contacts, handle corporate relations issues (IFC is often portrayed as a blue chip/unique investor with global knowledge of best practices), have the stature to speak to experts in crisis management and macro-economic restructuring, and tap opportunities when they arise.

The investment negotiation and processing must often be handled in an "urgent" mode leading to deal closing within a compressed time frame (about 2 months). The time crunch can be eased, for example, by recycling a tested legal structure and having clear investment strategies and good deal targeting. Most of all, the investment officer must know how to leverage IFC's field presence and work across time zones.

Teams working on initiatives related to IFC's response to the current global crisis have high-profile assignments and should be acknowledged within the Corporation. Corporate Relations should also highlight the work externally to showcase IFC's major initiatives and global leadership. This in turn will ease recruitment and deal sourcing and attract the best and the brightest to IFC.

5) Different teams should work on "work-outs" and "new investments"

The work-out unit usually works from a "zero" cost base, because most investments they work on have been fully provisioned, which can lead to restructuring decisions that may be different from those that are taken to make new investments generate future value. The work-out unit should continue to focus on the IFC jeopardy portfolio, while other investment teams should work on new deals with a goal of creating value through new investments.

6) Banks require special care during a financial crisis.

CEOs and senior management of banks must deal with shifting priorities, and they need to concentrate on loan-portfolio restructuring to address corporate and retail lending defaults and provisioning, bank recapitalization plans, and liquidity management. In addition, they need to address market rumors, public relations and staffing issues, and deal with stock market analysts, credit rating agencies, and external auditors. There is often intense interaction with government authorities, IMF, supervisory authorities and mergers with other banks, as we are witnessing today.

During a crisis, IFC can address some of the above issues through frequent interaction with the bank's management team, quickly reacting to breaking news, sharing macro-economic views and staff experience, providing corporate governance plans, tailoring advisory services to the Bank, and mobilizing top-notch expertise to address particular issues.

Special care must be paid to valuation and due diligence considerations. A crisis typically leads to market distortion in the banking sector, and this can impair a traditional bank's due diligence approach. During a crisis, the quality of a bank's management team must be assessed, as well as its strategy and its willingness to accept IFC as a shareholder. Agreement must be reached on the implementation of measures to create shareholder value. All of the above, plus good timing of IFC equity investments, may rank as more important factors in bank valuation than the traditional asset quality/capitalization criteria used during non-crisis times. Some examples of market distortions impacting the assessment of the value of equity in banks include: bank mergers and nationalizations; state guarantees on deposits equalizing risks across banks; state-sponsored agencies buying bad loan portfolios based on non-market prices; and exacerbated currency movements in foreign exchange markets, making it preferable to invest equity after local currency depreciation.

Banks should also be appraised on a comparative basis relative to country or regional peers.

After IFC's initial investment, there are a number of issues that IFC should address. IFC should be prepared to help banks value the quality of their loan portfolio. Banks should consider rotating front-office investment staff to portfolio/back-office functions so that they work on portfolio restructurings instead of

booking new assets which cannot be funded due to the lack of liquidity in the banking system during a crisis. In addition, the banks' equity portfolio should be parked under a separate vehicle (not the bank's balance sheet) and managed by appropriate teams of experts.

IFC and banks should develop expertise in accounting areas, because many issues involved in restoring market confidence are also linked to banks' financial disclosure.

7) IFC must work closely with local authorities, the World Bank, and the IMF.

Liaising with local authorities at a very senior level (Governor of the Central Bank, Minister of Finance, etc.) and relevant Executive Director offices in Washington to "sell" IFC's investment program requires special care. These meetings should highlight that IFC's products and services are tools to help strengthen the private sector of a particular country, thus it is important to outline private sector priorities and determine where IFC can be most effective.

In the case of Korea, we found that both the WB and IMF sent highly qualified experts to crisis countries. There is a firewall between IFC on one side and the WB/IMF on the other, due to a conflict of interest between IFC's private sector investments at the company level and policies at the country level. However, WB and IMF experts do speak to many market participants, and it is important for IFC investment staff to be among those who are consulted at the project/country level in order to share knowledge and increase IFC's contribution to a crisis country.



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